



Improving Allocation

Performance-based allocation is feasible ...

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Introduction

Allocation methodologies
The question of auctioning
Benchmarking as solution



Allocation methodologies

- Question effective ETS: Scarcity of allowances sufficient ?
 - Lesson learned: allocation method is equally vital (Grubb, Delbeke)
- Historical grandfathering poses fundamental challenges
 - Uncertain incentive for improvement, “updating” problem
 - Short allocation new plants → highly distorting transfer rules, barrier to entry – enhancing market concentration;
 - Unsolvable dilemmas new entrants (NE) & closures (C) (see e.g. also Grubb and Neuhoff, 2006)
 - Theory says: freeze allocation [all allowances after C & zero for NE]
 - Zero for NE actually hinders low carbon investments / competitiveness
 - Retaining allowances after C – how long? – is worse than transfer rules
 - Withdrawal allowances after C: perverse incentive keeping inefficient plants operational
 - Other fundamental challenges not addressed here
 - “Leakage”, distortions of free market, economic rents (see A. Loske)
- Therefore focus on benchmarking or auctioning



The question of auctioning

- Serious concerns
 - Competitiveness is undermined – Lisbon strategy
 - Same “leakage” as present rules
 - Recycling of revenues poses challenges for effectiveness
 - Revenues with Member States – outside EU jurisdiction – create temptations: recycling but also investments in “nice things” etc., which also create Internal Market distortions

- A present trend: benchmarks for industry & auctioning for electricity to counter windfall profits issue
 - Electricity prices remain highly impacted – competitiveness
 - 45% EU electricity CO₂-free (nuclear, hydro, other) – will increase
 - Recycling to users by far insufficient – take France - distortions
 - Plus general problems mentioned above

- Partial auctioning - also no solution



Benchmarking as solution

Benchmarking addresses fundamental problems

- Key principles & general technical criteria addressed here
- Allowances must be allocated in relation to actual production to solve major problems (see presentation A. Loske)
- Concept of practical approach: apply Pareto analysis
 - Benchmarks of “the vital few” (20% of products) cover 80+% of emissions, which holds for each sector (electricity 100%)
 - Too many benchmarks of “the trivial many” not feasible, minor impact – special solutions, guiding principle: “be generous”



True benchmarks give same incentive as auctioning for an ETS

Same incentive for low carbon technologies

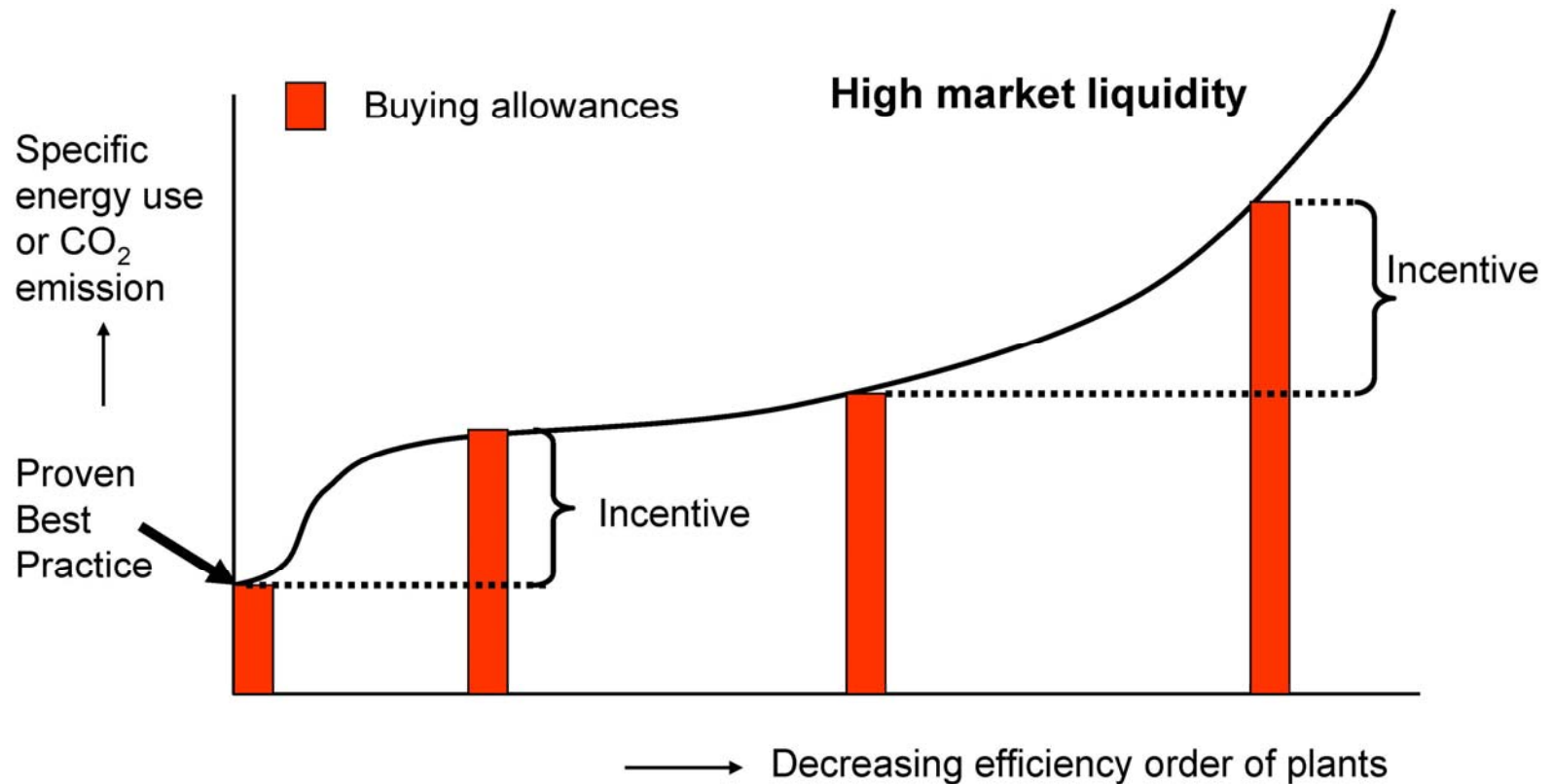
Suitable benchmark formula

Experience shows it works



Auctioning:

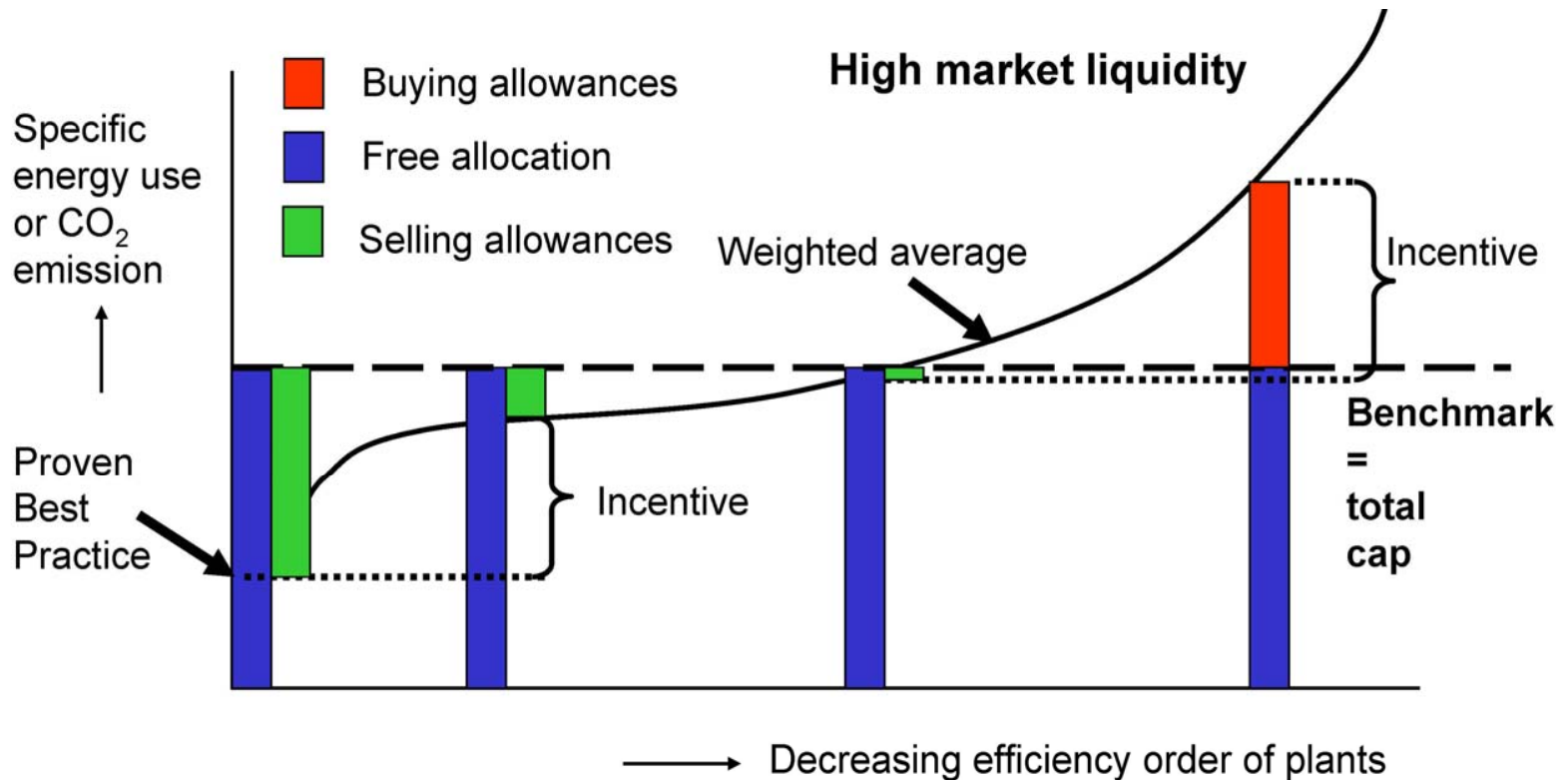
Clear incentive for low carbon technologies, but emissions leakage & detrimental for competitiveness





Performance-based allocation:

Same incentive as auctioning, (hardly or) no leakage,
good for competitiveness





Key principles of benchmarking

What a CEO wants to know
Why is it always stimulating?



Key principles of benchmarking (1)

➤ **What a CEO wants to know?**

- He wants to know – e.g. with cost-price:
 - Where his plants stand?; then
 - Why? + What can be done about it?
- He refuses notions like “We are the best in the peer group of our [obsolete] technology, or in our [small] scale, or in our plant vintage” (many corrections make everyone equal)

➤ **Key principle: benchmarks relate**

- The product
... with
- the objective function – CO₂ in the EU ETS
- Deviations shall be possible, but temporary and aimed to
 - avoid leakage outside EU (... objective function)
 - safeguard competitiveness (... objective function)
- Example: energy efficiency as objective function can avoid leakage by switch to gas and shipping of carbon-rich fuels outside EU



Key principles of benchmarking (2)

- Same benchmarks for incumbents and new plants
 - Avoid
 - Distorting transfer rules
 - Barriers to entry
 - Enhanced market concentration
 - Ensure
 - Equal incentive for plant improvement & plant replacement
 - No “maximisation” or “minimisation” rules (NL 110% and 85% now)



Benchmarking: clear incentive to reduce emissions

- Incentive to reduce emissions is independent of the exact value of benchmark in a certain year

Incentive = avoided purchases + possible sales of allowances

Example:

Investment to reduce emissions from 900 to 600 kg CO₂ per unit of product (in old plant or new plant)

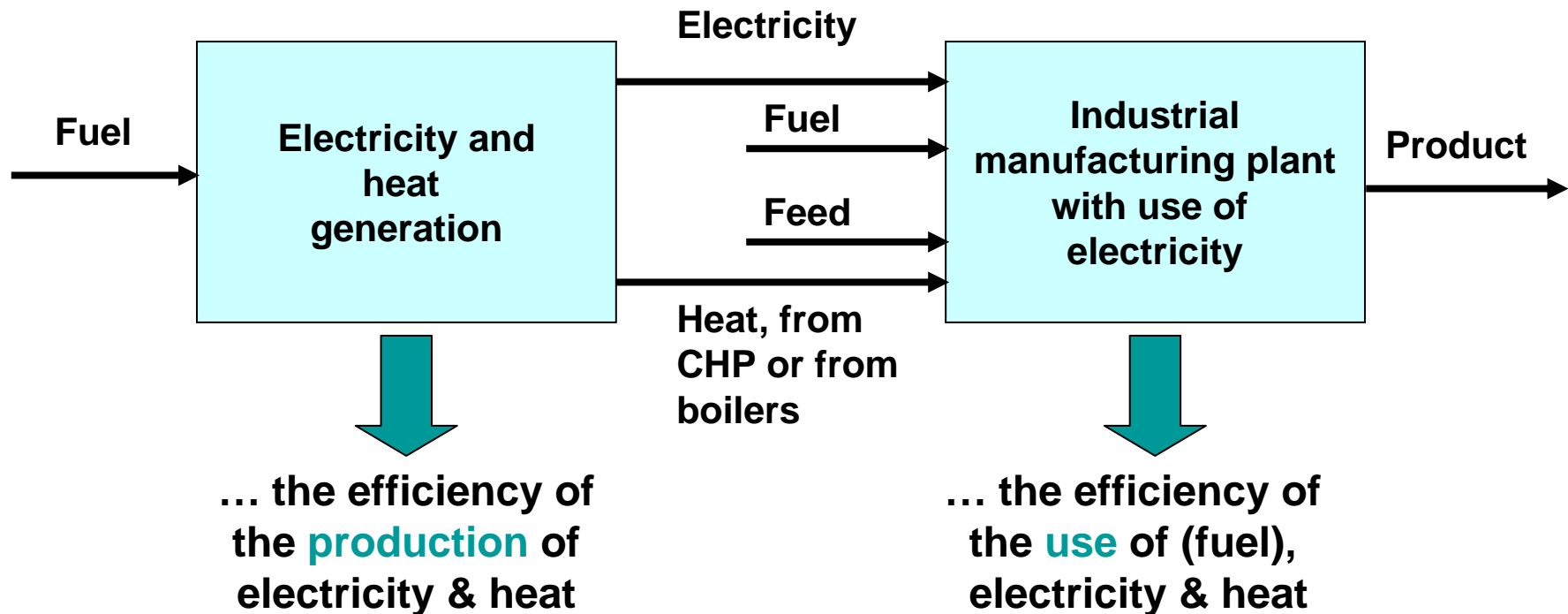
- Year 1, BM = 750: incentive = 150 + 150 = 300
- Year n, BM = 700: incentive = 200 + 100 = 300

➔ Predictability of investment climate



Benchmarking in the product chain

Benchmarking provides incentives in the whole product chain ...





Transition with performance-based allocation for a faster global trading scheme

